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RUEHUL/AMEMBASSY SEOUL PRIORITY 2634
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C O N F I D E N T I A L SECTION 01 OF 02 MOSCOW 012930

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SUBJECT: RUSSIAN ENERGY: AMBASSADOR MEETS WITH SHELL ON
SAKHALIN-2

Classified By: DCM Daniel A. Russell. Reasons 1.4 (b/d).

1. (C) SUMMARY. On December 14, the Ambassador met with Chris Finlayson (U.K. citizen), head of Shell's Russia operations, and Alf D'Souza (Australian citizen), Shell's VP for corporate affairs, to discuss the latest developments on the Sakhalin-2 project. Finlayson characterized negotiations with Gazprom as having progressed well until very recently. On December 13, Gazprom came in with an unacceptably low offer of \$2.6 billion for a 50 percent stake in the project. The figure is lower than previous offers because Gazprom is factoring in the costs from the environmental damage from the project reportedly found by the GOR. The CEOs from Sakhalin Energy's three shareholders will meet with senior Russian officials on December 15 but, in the event these meetings are unsuccessful, the consortium appears to be examining all options, including arbitration. END SUMMARY

TWO DAYS AGO...

2. (C) Finlayson said that up until December 13 the negotiations regarding Gazprom's entry into Sakhalin-2 project had been progressing well (Note: Sakhalin-2 is being developed by Sakhalin Energy (SE), made up of Shell and the Japanese companies Mitsubishi, and Mitsui. Shell is the operator of the project). The two sides had reached closure on six of the seven principles that they had agreed would form the basis of the deal and Shell and its Japanese partners had agreed to sell Gazprom a 50 percent stake. The outstanding issue was the value of that stake. Finlayson said that Gazprom and SE were about \$2-3 billion apart, an amount he viewed as bridgeable. Gazprom proposed -- and SE accepted -- that the final valuation would be based on the assumption that Gazprom had entered the project on the ground floor.

...AND YESTERDAY

3. (C) At a meeting on December 13, Alexander Medvedev, Gazprom's Vice Chairman and negotiator on the Sakhalin-2 project, informed Finlayson that Gazprom's Chairman Alexey Miller had examined the file on the environmental accusations

made against SE by Oleg Mitvol, deputy head of the Ministry of Natural Resources' environmental watchdog agency, Rosprirodnadzor. Miller concluded that the environmental damages -- \$10 billion worth -- should be factored into the negotiations. As a result, Medvedev said that Gazprom was willing to offer only \$2.6 billion for the 50 percent stake. Finlayson said this was a "silly" offer significantly below earlier offers and that it was not within his remit to even discuss such a low figure. These comments track with what the Ambassador was told by the U.K. Ambassador Anthony Brenton (please protect), who said that press coverage of the negotiations did not accurately reflect the difficulties the two sides were having coming to closure.

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WHAT NOW?

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14. (C) Finlayson said that Shell has engaged "high-level third party intervention" (but did not say who) to talk to the GOR. In addition, on December 15 the CEOs for Shell, Mitsubishi, and Mitsui will come to Moscow to meet with Miller and Energy Minister Viktor Khristenko. If these meetings are not fruitful, Finlayson said that the partners are preparing other options, including those under various bilateral treaties and arbitration as well as altering their neutral and even positive media stance about the negotiations to a chillier and more negative one. He said that even if they wanted to do what Gazprom is asking of them, they could not because senior managers would have to answer to shareholders and they worry about this "contagion" spreading to other countries in which they do business. In a separate conversation with the Ambassador, Japanese Ambassador to Russia Yasuo Saito (please protect) said that there is a good chance that the Japanese companies, by contrast with Shell,

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would cave-in to Gazprom's demands because they are under a lot of pressure in Japan to deliver the gas. Finlayson said that there "very likely" will be further production delays as a result of these negotiations and the recent removal of water use licenses on some stretches of the gas pipeline on Sakhalin Island and affecting drilling permits.

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SHELL'S ANALYSIS

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15. (C) Finlayson said that it was hard to tell where this issue would go from here and how much of this was negotiating bluff on the part of Gazprom. He said Medvedev's body language indicated that he felt extremely uncomfortable relaying this message from Miller. Further, some on Shell's team heard that Miller was not happy with this decision either but had been ordered "from above" to launch it. Finlayson noted that the \$10 billion in environmental fines has no basis in Russian law. By comparison, despite all the hoopla in the media recently, the fines from the formal charges against SE amounted to \$10,000 in administrative, not criminal, fines and were primarily centered around the work performed by Russian subcontractors.

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